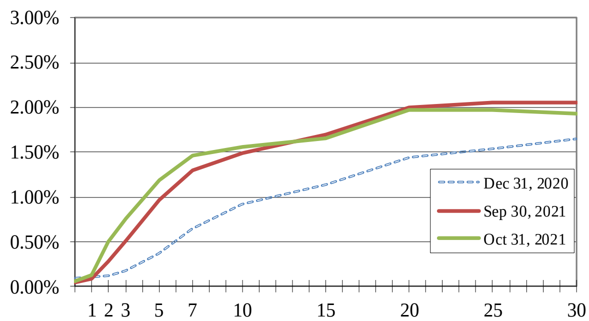
Baird Advisors
Fixed Income Market Commentary
October 2021

Expectations for Fed Policy Shift, Treasury Curve Flattens, Planned Fiscal Programs Downsized

The 10yr Treasury yield continued its recent trend higher this month, rising another 7 bps during October though it ended the period at 1.55%, down 15 bps from the intra-month high mark of 1.70%. The most noteworthy yield change this month was the significant flattening between the 5yr and the 30yr segment of the curve. The 30yr Treasury yield fell by 11 bps to 1.93% (interestingly, below that of the yield on 20yr Treasuries, leading to the first inversion of this curve segment since the 20yr was reintroduced last year), while 5yr yields rose by 22 bps. This flatter slope reflects shifting expectations on the pace of Fed policy. While Q3 GDP (2.0%) and recent payroll data (+194,000) were below consensus expectations, the 5.4% headline CPI figure for September emboldened the view that the Fed will tighten its policy rate earlier than expected. This shift in outlook – from one hike to two next year – is expressed most visibly in the 2yr Treasury yield movement. Before hiking its policy rate, the Fed has reiterated its expectation to taper monthly purchases of Treasuries and mortgages, impacting valuations and tone in both asset classes. Despite the Fed likely reducing its purchases soon, mortgage spreads continued to grind tighter in October. Credit markets fared well in recent weeks on strong earnings and in response to the updated framework for the Build Back Better legislation. Corporate income tax rates, which were previously expected to climb, are now poised to remain the same with new revenue instead coming from a 15% minimum tax on the declared income of large corporations and 15% tax on net foreign income (GILTI). President Biden's recent $1.75T proposal is notably smaller than the initial $3.5T but contains several elements that he planned to tout during his European trip for the G20 and UN Climate Change conferences.

Treasury Yields



Maturity	12/31/20	9/30/21	10/31/21	1Mo Chg	YTD Chg
3 Mo	0.09%	0.04%	0.06%	0.02%	-0.03%
1	0.11%	0.08%	0.13%	0.05%	0.02%
2	0.12%	0.28%	0.50%	0.22%	0.38%
3	0.17%	0.51%	0.76%	0.25%	0.59%
5	0.36%	0.97%	1.19%	0.22%	0.83%
7	0.65%	1.29%	1.46%	0.17%	0.81%
10	0.92%	1.49%	1.56%	0.07%	0.64%
30	1.65%	2.05%	1.94%	-0.11%	0.29%

Credit Wider, Mortgages Tighter in October; Both Tighter YTD

Corporate spreads moved a modest 3 bps wider for the month on heavy issuance. The corporate market successfully priced $21B of AerCap debt, which was the second largest transaction this year behind only the $25B from Verizon. Agency Mortgage prepayment model changes create a false appearance of outperformance in the mortgage sector (-3 bps MTD, -15 bps YTD). EM debt experienced the largest move with 9 bps of spread widening in October. Changes in swap spreads – the reference benchmark for ABS – contributed to the sector moving 7 bps wider.

Agg Returns Modestly Negative in October; YTD Remains Negative

The Aggregate Index return was negative in October (-0.03%) but the Corporate component produced positive monthly total returns (0.25%). TIPS was the top performing sector for the month (1.13%) and YTD periods (4.69%). High Yield Corporate debt produced narrowly negative returns in October (-0.17%) and has provided the second-highest sector returns thus far in 2021 (4.36%). Emerging Market debt produced the weakest sector results in October (-1.11%).

Option-Adjusted Spreads (in bps)

	12/31/20	9/30/21	10/31/21	1Mo Chg	YTD Chg
U.S. Aggregate Index	42	33	33	0	-9
U.S. Agency (non-mortgage)	10	3	5	2	-5
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	39	27	24	-3	-15
U.S. Agency CMBS	44	29	27	-2	-17
U.S. Non-Agency CMBS	109	85	87	2	-22
Asset-Backed Securities	33	29	36	7	3
Corporate Sectors					
U.S. Investment Grade	96	84	87	3	-9
Industrial	101	88	90	2	-11
Utility	106	96	96	0	-10
Financial Institutions	83	75	79	4	-4
Non-Corporate Credit	66	52	54	2	-12
U.S. High Yield Corporates	360	289	287	-2	-73
Emerging Market Debt	503	581	590	9	87

Source: Bloomberg Indices

Total Returns of Selected Bloomberg Indices and Subsectors

	October	YTD	Effective Duration (years)
U.S. Aggregate Index	-0.03%	-1.58%	6.74
U.S. Gov't/Credit Index	0.05%	-1.88%	7.62
U.S. Intermediate Gov't/Credit Index	-0.56%	-1.43%	4.14
U.S. 1-3 Yr. Gov't/Credit Index	-0.33%	-0.24%	1.92
U.S. Treasury	-0.07%	-2.56%	7.09
U.S. Agency (Non-Mortgage)	-0.42%	-1.15%	3.96
U.S. Agency Pass-Throughs	-0.19%	-0.86%	4.63
CMBS (Commercial Mortgage Backed Securities)	-0.39%	-0.92%	5.11
ABS (Asset-Backed Securities)	-0.35%	-0.11%	2.31
U.S. Corporate Investment Grade	0.25%	-1.02%	8.71
U.S. High Yield Corporates	-0.17%	4.36%	3.98
Emerging Market Debt	-1.11%	-1.95%	5.49
Municipal Bond Index	-0.29%	0.50%	5.19
TIPS (Treasury Inflation Protected Securities)	1.13%	4.69%	7.83

Disclosures

This is not a complete analysis of every material fact regarding any company, industry or security. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks such as interest rate risk, credit risk, inflation risk, and liquidity risk. In a rising interest rate environment, the value of fixed-income securities generally decline and conversely, in a falling interest rate environment, the value of fixed-income securities generally increase. High yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield.

Indices are unmanaged, and are not available for direct investment. *Past performance is not a guarantee of future results.*

The Bloomberg U.S. Aggregate Bond Index is an index comprised of approximately 6000 publicly traded bonds including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

The Bloomberg Government/Credit Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt.

The Bloomberg Intermediate U.S. Government/Credit Bond Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt with maturities between one and ten years.

The Bloomberg 1-3 Year U.S. Government/Credit Bond Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt with maturities between zero and three years.

The Bloomberg U.S. Treasury Index includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint of at least one year but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting. Securities in the Index roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices. The U.S. Treasury Index was launched on January 1, 1973.

U.S. Agency: This index is the U.S. Agency component of the U.S. Government/Credit index. Publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities). The largest issues are Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLB). The index includes both callable and non-callable agency securities.

U.S Corporate – Investment Grade: This index is the Corporate component of the U.S. Credit index. It includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

CMBS (Commercial Mortgage-Backed Securities): This index is the CMBS component of the U.S. Aggregate index. The Bloomberg CMBS ERISA-Eligible Index is the ERISA-eligible component of the Bloomberg CMBS Index. This index, which includes investment grade securities that are ERISA eligible under the underwriter's exemption, is the only CMBS sector that is included in the U.S. Aggregate Index.

MBS (Mortgage-Backed Securities): This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates.

ABS (Asset-Backed Securities): This index is the ABS component of the U.S. Aggregate index. The ABS index has three subsectors: credit and charge cards, autos, and utility. The index includes pass-through, bullet, and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche. The Manufactured Housing sector was removed as of January 1, 2008, and the Home Equity Loan sector was removed as of October 1, 2009.

Corporate High Yield: The Bloomberg U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

Emerging Market: Bloomberg uses a fixed list of countries defined as emerging markets countries for index inclusion purposes that is based on World Bank Income group definitions (Low/Middle), IMF country classifications (Non-Advanced Economies), and other advanced economies that may be less accessible or investable for global debt investors.

The Bloomberg Municipal Bond Index is a broad-based, total-return index. The bonds are all investment-grade, tax-exempt, and fixed-rate securities with long-term maturities (greater than 2 years). They are selected from issues larger than $50 million.

The Bloomberg TIPS Index consists of Treasury Inflation Protected Securities (TIPS). TIPS are securities whose principal is tied to the Consumer Price Index. TIPS pay interest semi-annually, based on the fixed rate applied to the adjusted principal.

Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment grade investments are those rated from highest down to BBB- or Baa3.

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